Testimony of Mark Murphy, Fiscal Policy Analyst
American Federation of State, County and Municipal Employees (AFSCME)
Before the Finance, Revenue and Bonding Committee
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I am pleased to present testimony in favor of the bills before the committee today: House Bills 6348, 6349 and 6350, and Senate Bills 806, 807, 808 and 815. In several different ways, these bills will allow Connecticut to take back control over its tax code. I will concentrate today on Raised Bills 6349 and 6350, dealing with tax expenditures.

The bills eliminate a number of exemptions from the sales and use tax and Raised Bill 6350 also lowers the rate of the tax. These bill represent sound tax policy, which calls for low tax rates on as broad a base as possible. While we do not know the net fiscal impact of RB 6350 as written, we believe it takes Connecticut in the right direction.

Not all tax expenditures are wasteful. In some cases, a tax incentive can accomplish a public policy goal as effectively as a program. Tax expenditures such as low-income credits are also an effective way to make the distributional impact of state and local taxes more fair.

However, one of the built-in drawbacks of tax expenditures is the lack of oversight and review. Typically, once a tax exemption has been enacted, it carries over from year to year in the tax code without any formal, scheduled review. Contrast this to the treatment of appropriated programs, which are subject to competition for funding in the biennial budget, as well as a host of budget office audits, performance measures and other reviews. Difficult budget times, such as we are experiencing now, habitually bring regretful statements about making difficult choices, and about no area of spending being immune to cuts. Yet as often as we hear these kinds of statements, it is rare for lawmakers to put tax expenditures through more than a cursory review. This is why some call tax expenditures the "roach motels" of state budgets – they go into the tax code, but never come out.

I would like to discuss four problems we find with some tax expenditures: even the well-meaning ones tend to be inefficient; they exempt services for no compelling reason; they are often ineffective; and they create inequities among taxpayers.

Tax Expenditures Are An Inefficient Means of Implementing Policy

Many tax expenditures are well-intentioned but are terribly inefficient, because they are poorly targeted. For example, Connecticut has an exemption for clothing and footwear costing less than $75 (up from $50 last year), at a cost of $130 million in foregone revenue. The goal is a good one: to shield low-income families from the regressive nature of the sales tax on necessities. Unfortunately, as the Institute on Taxation and Economic Policy found when analyzing this exemption, the 40 percent of Connecticut households earning less than $39,000 per year receive only 15 percent of the benefit of this tax break. Nearly half of the benefit goes to the highest-income 20 percent of taxpayers, households making over $100,000 per year. Millionaires get an average benefit of $795 per year, while households making $31,000 per year receive only $34.

The same goal could be achieved more efficiently by repealing the clothing exemption and replacing it with an offsetting low-income tax credit. After the offsetting credit, this change would save the state $100 million or more in tax revenues.[1] It is worth noting that New York Governor David Paterson has proposed repealing the clothing exemption, even without an offsetting credit.

Similar tax exemptions exist for weatherization products, energy-efficient appliances, bicycle helmets, firearm safety devices and even vegetable seeds. The purpose of the tax breaks is to provide an incentive for greater use of these goods. However, these incentives are likely as poorly targeted as the clothing exemption, with the bulk of the benefit going to those who do not need the tax break to afford them. The measures also suppose that state residents are widely aware of the tax breaks to influence their behavior, which we doubt. It is more likely that the tax exemption serves as a windfall that is discovered after the purchase is made, if at all.

Consumption of Services Should Be Treated Like Consumption of Goods

There is no tax policy rationale for treating consumption of services differently than consumption of goods; the exemption of services is due to historical accident. Adding services to the sales tax base, as Raised Bills 6349 and 6350 do, allows the sales tax to stay current with consumption patterns which have been shifting to services for decades.

The state's Tax Expenditure Report lists 18 services which are not currently taxed and would be appropriate to include in the tax base, such as computer processing, vessel maintenance, parking, car washes, massage and hair removal, home repair, and admissions. These services total over $120 million in foregone revenue. Additional services are listed as exempt in the Federation of Tax Administrators' 2007 survey, including veterinary services, pet grooming, limousines, barber and beauty shops, and laundry services.[2] Depending on the scope of additional services added to the sales tax base, the sales tax rate could be lowered while still generating additional needed revenue during this fiscal crisis.

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[1] Institute on Taxation and Economic Policy, personal communication, February 6, 2008. Analysis available upon request.

[2] Federation of Tax Administrators, "Sales Taxation of Services," http://www.taxadmin.org/fta/pub/services/services.html, visited February 8, 2009.

Tax Expenditures Are Often Ineffective

Many costly tax expenditures would fail the first requirement of appropriated spending programs, that is, evidence of effectiveness. For example, economic development tax credits are intended to attract and retain jobs. However, as the National Conference of State Legislatures found in their examination of development incentives, "many states do not have the data to conduct this type of analysis, don't know how to create the data, or don't understand how to measure the costs and benefits (including externalities) of economic development."[3] AFSCME, along with the Council on State Taxation and other business and labor groups, participated in this NCSL study. The goal of economic development is one that this diverse group shared. We all have an interest in economic growth that raises living standards and our quality of life. But we are alarmed at the sums spent without evidence that these incentives actually work, and work better than other uses of that money.

According to the state's Tax Expenditure Report, Connecticut prepared to spend over $90 million this year on tax credits for job creation and capital investment, another $115 million on film and media production credits, another $30 million for companies to invest in neighborhood redevelopment or historic home rehabilitation, and $20 million on various research and development credits. Over $175 million of these tax expenditures were enacted or expanded since 2004. Connecticut should have a much better sense of what it is getting for that increasing investment than it does at present. (This is one reason why Raised Bills 815 and 6348 are needed.)

Tax Expenditures Create Inequitable Tax Treatment

Another adverse result of the proliferation of tax expenditures is a growing inequity in the tax system, where similarly situated taxpayers are treated differently by the tax code. Over the years, the state has extended favorable treatment to the auto dealership, aviation, biotechnology, film, insurance, railroad and printing industries, for example, giving those companies significant tax advantages over other firms whose investments produce equal benefits to the state. This means that the non-favored industries must bear a greater share of the tax burden than they would if the tax code were more neutral, and the overall revenue available to the state is reduced.

In conclusion, the bills before the Committee today provide an opportunity to make progress in Connecticut's tax code and budget process, in terms of fairness, accountability, and transparency, and as such they have AFSCME's support.

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[3] National Conference of State Legislatures, "Economic Development Partners," August 20, 2007, http://www.ncsl.org/programs/econ/EDpartners.htm, visited February 7, 2009.